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19 September 2008

Committee Secretary
Senate Economics Committee
Department of the Senate
PO Box 6100
Parliament House
CANBERRA ACT 2600

Via email to: economics.sen@aph.gov.au

Dear Sir/Madam

Senate Economics Committee Inquiry into the Disclosure regimes for charities and not-for-profit organisations

The Australian Institute of Company Directors (AICD) welcomes the opportunity to make a submission to the Senate Economics Committee on disclosure regimes for charities and not-for-profit organisations (NFPs).

The AICD is a member institute for directors that is dedicated to making a positive impact on the economy and society by promoting professional directorship and good governance. AICD delivers education, information and advocacy to enrich the capabilities of directors, influence the corporate governance environment in Australia and promote understanding of the role of directors.

With offices in each state and more than 23,000 members, AICD represents a diverse range of corporations, from the top 200 publicly listed companies to NFPs, public sector entities and smaller private family concerns. Many of our members are involved in the not for profit sector in a paid capacity and as volunteers. AICD is structured as an unlisted public company limited by guarantee, and as such is directly affected by the NFP regulatory environment. We express our views both as an NFP and as a representative of members with interests in the NFP sector.

There have been numerous enquiries and reports pertaining to the NFP regulatory and reporting environment over the past decade. AICD strongly urges the Committee to consider the vast body of past and concurrent work in this complex area. Key points from our submission, which follows, include:

- Current disclosure regimes are not appropriate and could be improved:
 - The governance regulation of NFPs should be simplified

- Further research should be conducted into size thresholds to provide reporting and auditing relief for smaller NFPs
- A separate NFP accounting standard should be created by the Australian Accounting Standards Board, including appropriate recognition of the needs of small NFPs
- There should be a single method of reporting to government grantors
- Models of regulation and legal forms are fragmented and overly complex, which could be resolved by having a single national regulator
 - There should be a single national regulatory regime covering all NFPs, however constituted based on size thresholds
 - The single national regulator – whether it be ASIC or a standalone regulator – needs to be adequately resourced to undertake both an educative and a compliance role
 - The business judgement rule (see s180(2) Corporations Act 2001) should be expanded to regulation affecting NFPs so as not to dissuade people from taking up directorships in the sector
- Other measures to improve governance, standards, accountability and transparency in use of public and government funds:
 - Widespread consultation and detailed consideration of the vast body of previous work in this area needs to be undertaken before any new system is put in place
 - Any new regulation of the NFP sector should be reviewed in light of the *Business Checklist for Commonwealth Regulatory Proposals*

AICD believes that a ‘light touch’ needs to be applied in reforming NFP regulation so that volunteers and donors are not dissuaded by red tape from contributing their time, expertise and money to the sector. Cost burdens need to be balanced against the benefits of any regulatory regime.

If you require further information on any of our views please contact me or Helen Eyles at heyles@companydirectors.com.au

Yours faithfully



John H C Colvin
Chief Executive Officer

Introduction

Of the approximately 700,000 NFPs in Australia, an estimated 150,000 are incorporated.¹ It has been estimated that nearly 90 per cent of adult Australians belong to an NFP.² Many of AICD's members are active in the NFP sector, as directors and in other paid and voluntary capacities. AICD is itself an NFP, structured as a company limited by guarantee under the *Corporations Act 2001* (*Corporations Act*).

There are a number of recent and pending reports and enquiries relevant to the NFP sector, including:

- Industry Commission inquiry report on Charitable Organisations in Australia (1995) – which produced 31 recommendations including uniform fundraising legislation, a uniform form of incorporation, and an accounting standard for community social welfare organisations³
- Report of the Inquiry into the Definition of charities and related organisations (June 2001) – which produced 27 recommendations, none of which have been acted upon to date⁴
- The “Woodward Report” on reforming not-for profit regulation (2004) – an in-depth survey and analysis of the NFP sector, with detailed recommendations for reform, by the Centre for Corporate Law and Securities Regulation at the University of Melbourne, with support from Philanthropy Australia Inc⁵
- *NFP: a research project* (2006) – a publication of the Institute of Chartered Accountants in Australia (ICAA) to provide assistance to the NFP sector in applying NFP reporting requirements.⁶
- *Financial Reporting by Unlisted Public Companies* (June 2007) – discussion paper by the Commonwealth Department of the Treasury⁷
- The Australian Accounting Standards Board's ITC 14 *Proposed Definition and Guidance for Not-for-Profit Entities* (December 2007)⁸
- New South Wales exposure draft *Associations Incorporation Bill 2008* - a project to update that State's legislation, including provision of auditing relief for smaller associations⁹

Each of these reports and enquiries make clear that reform of the NFP sector is needed. The national regulatory scheme for for-profit companies is well entrenched,

¹ “Reform is vital for non-profits,” *Australian Financial Review*, 2 September 2008, p. 63

² Ibid

³ Charitable Organisations in Australia, Industry Commission Report No. 45, released 16 June 1995, available at: <http://www.pc.gov.au/ic/inquiry/45charit>

⁴ <http://www.cdi.gov.au/html/report.htm>

⁵ Woodward and Marshall, *A Better Framework: Reforming Not-For-Profit Regulation*, The University of Melbourne (2004), available at: <http://cclr.law.unimelb.edu.au/index.cfm?objectId=017B1CA1-B0D0-AB80-E29B8B41F029F841>

⁶ <http://www.charteredaccountants.com.au/files/documents/Not-for-Profit-Report.pdf>

⁷ <http://www.treasury.gov.au/contentitem.asp?NavId=037&ContentID=1269>

⁸ <http://www.aasb.gov.au>

⁹ http://www.fairtrading.nsw.gov.au/About_us/Reviews_and_reports/Public_consultation_papers_archive/2008.html

through the *Corporations Act*, but there has been no similar progress for Australia's estimated 700,000 NFPs.

The fact that there are so many interrelated proposals means it is vital for any reform to be undertaken as a coordinated effort by all levels of government and the accounting and auditing standards setters.

There are clear differences between for-profit companies and NFPs. In addition to having social objectives and favourable tax treatment, business efficiency is not an end in itself. Rather, it is effectiveness in achieving long-term social impact.¹⁰ NFP regulation must accommodate these differences but unfortunately this is not often the case. The complexity of the governance and reporting regime for NFPs results in the misallocation of all forms of scarce NFP resources – funds raised by donation or received as grants, volunteer time, and management time.

Concern has been expressed about the general impact of incremental governance regulation on companies generally. The resourcing implications are more significant for NFPs than they are for other companies because they have fewer resources at their disposal.¹¹ At the same time, directors of NFPs can be subject to the same duties and exposure to personal liability as directors of for profit companies. This may act as a deterrent to individuals who wish to volunteer their time and expertise to assist NFPs. If the NFP sector is to continue to make a valuable contribution to the Australian economy and society, its governance and reporting requirements need to be simplified.

The relevance and appropriateness of current disclosure regimes for charities and all other not-for-profit organisations

Current disclosure regimes are not appropriate and could be improved

Current NFP disclosure regime too complex and fragmented

NFPs may be structured in a variety of ways, including companies limited by guarantee, statutory bodies, trusts, co-operatives and incorporated associations.¹² Statutory bodies may fall under the *Corporations Act* or under their own legislation. Companies limited by guarantee are governed by the *Corporations Act*. Associations are regulated by state offices of fair trading or consumer affairs under state-based legislation.

The accounting and auditing requirements for NFPs vary according to jurisdiction and across the various legal structures. The submission by the Institute of Chartered

¹⁰ Gabrielle Upton "Business Lessons from Not-for-profit Governance", *Company Director*, June 2008, p48

¹¹ Gabrielle Upton "When Size Matters - in Search of more Meaningful Ways to Regulate Small Corporations", *Company Director*, August 2007, p38

¹² According to the Law Council of Australia's submission to this Inquiry, there are more than 20 ways in which an NFP may be incorporated.

Accountants in Australia to this Inquiry presents a table of the most common financial reporting and auditing requirements that may apply to NFPs, i.e. those affecting associations and companies limited by guarantee. There are also state-based laws on fundraising or gaming that have to be complied with if an NFP is running raffles and other events to raise money.

It should be noted that some companies limited by guarantee are quite small, and some associations have grown to the extent that they are larger than some companies limited by guarantee and have interstate branches.¹³ And some of Australia's largest NFPs are neither companies limited by guarantee or incorporated associations, but rather were created by their own Acts of Parliament.¹⁴ It is also worth noting that the 11,000 or so companies limited by guarantee represent only a very small proportion of the estimated 700,000 NFPs in Australia.

Later in this submission, under 'Models of Regulation and Legal Forms', we offer our suggestions for how NFPs might be better regulated including being brought under a single national regulator. In this section we discuss issues specific to disclosure under the accounting and auditing standards.

Burden on public companies limited by guarantee

Unlisted public companies limited by guarantee (the vast majority of which, like AICD, are NFPs), must comply with the financial reporting requirements of the *Corporations Act*. There are no size thresholds for unlisted public companies similar to those available to proprietary companies. Therefore currently an unlisted public company limited by guarantee must comply with the accounting standards and have its financial report audited. This can impose a substantial cost on smaller NFPs.

Financial reporting for unlisted public companies has become even more difficult with the adoption in Australia of the International Financial Reporting Standards, along with the decision to maintain sector neutral accounting standards. The international standards are designed for listed companies and other participants in capital markets such as insurance companies and banks. It is widely recognised that the current suite of international standards (which Australia adopts for all reporting entities) can impose significant costs, without associated benefits, on smaller entities. The International Accounting Standards Board is working on a simpler international standard for small and medium sized entities, but this standard will still be designed for 'for profit' businesses.

¹³ The 'company limited by guarantee' structure is explained in detail in the 2007 Commonwealth Treasury discussion paper *Financial Reporting by Unlisted Public Companies*, available at: <http://www.treasury.gov.au/contentitem.asp?NavId=037&ContentID=1269>

¹⁴ An Industry Commission report noted that, as at 1995, fifteen of the largest 50 community social welfare organisations were incorporated under their own Acts of Parliament. Industry Commission Report No 45: *Charitable Organisations in Australia* (June 1995), para 8.2.4, available at: http://www.pc.gov.au/_data/assets/pdf_file/0007/6991/45charit.pdf

Need for a separate NFP accounting standard

A major impetus for the current inquiry seems to be concern that donors to charities are unable to discern how much of their donation that goes to charitable objectives and how much to administration, as highlighted in a recent *Choice* magazine article.¹⁵ AICD believes that these concerns would be alleviated through the creation of a standalone NFP accounting standard.

At the same time, an NFP accounting standard, in conjunction with appropriate exemptions for smaller NFPs, would operate to relieve the red tape burden and thereby free scarce resources to enable NFPs to better pursue their mission. The Woodward Report quotes a survey of Queensland NFP financial reporting, which found:

113 different line descriptions relating to direct labour costs
129 different revenue line items
836 different expense line items¹⁶

In the absence of a specific NFP accounting standard, the Australian Accounting Standards Board (AASB) has inserted specific paragraphs (Aus paragraphs) for NFPs into the 'for-profit' accounting standards in an effort to ensure the 'capital markets' based requirements of the international standards do not adversely impact on the NFP sector. However this has not provided a solution but instead resulted in a significant professional debate about the definition of NFPs and appropriate accounting treatments and disclosures for these entities. The AASB is currently working on a project to provide guidance on the definition of 'not-for-profit entity', but the development of a separate accounting standard applicable to NFPs is not on the AASB's current work plan.¹⁷

To remove confusion and complexity associated with the continuation of the current approach (for-profit standards with additional paragraphs), a separate NFP conceptual framework along with a separate NFP standard is needed. Similar frameworks are already in place in the USA and the United Kingdom. The International Accounting Standards Board's (IASB) proposed IFRS for Private Entities may turn out to be a suitable product for the Australian Accounting Standards Board to adapt for the NFP sector (assuming exemptions for smaller NFPs are made available). The final version of the international standard is expected next year.

An NFP specific approach to stakeholder reporting – with thresholds built in to properly reflect the various levels of accountability within the sector - could overcome the complexity resulting from the combination of the *Corporations Act*, Incorporated associations and fundraising legislation, and sector neutral Accounting Standards.

¹⁵ *Choice*, *Charities* (March 2008). Summary available at <http://www.choice.com.au>

¹⁶ Woodward Report, p. 196, quoting *Philanthropy and Nonprofit Matters*, Edition 24, September 2003 p. 2. The survey was conducted by the Centre of Philanthropy and Nonprofit Studies at Queensland University of Technology <http://cpns.bus.qut.edu.au>

¹⁷ ITC 14 Proposed Definition and Guidance for Not-for-Profit Entities (December 2007), available at: <http://www.aasb.gov.au/Work-In-Progress/Old/Pending/Comment-letters.aspx>

However AICD emphasises that any NFP accounting standard should be kept as cost-effective as possible to ensure that these entities spend their funds and resources on their objectives rather than on regulatory compliance for its own sake.

Such an accounting standard could also include specific reporting requirements relating to government grants. These requirements would have been agreed to by all government departments – federal and state – so that the financial report would be able to be used to satisfy the needs of all stakeholders.

Thresholds for reporting and auditing would assist smaller NFPs

A 2007 Treasury discussion paper on unlisted public companies canvassed options for a differential reporting regime for companies limited by guarantee. The aim of such a regime would be to grant reporting relief (and consequent red tape reduction) to a substantial number of unlisted public companies.¹⁸ A precedent for such differential reporting already exists in the *Corporations Act* exemptions granted to small proprietary companies.

AICD has commended Treasury for this initiative and is awaiting further developments with interest. AICD believes that Treasury is the best forum for consultations about appropriate thresholds for reporting relief for smaller NFPs.

AICD believes that a ‘light touch’ needs to be applied to regulation of the NFP sector, so that volunteers and donors are not dissuaded by red tape from contributing their time and money to the sector. Cost burdens need to be balanced against the benefits of any disclosure regime.

We recognise that reporting and audit thresholds for NFPs – especially charities – may need to be lower than those for proprietary companies, given the diversity of stakeholders (including donors, grantors, members, and volunteers). There is also a wide variety of skill levels among those managing NFPs, which may give rise to a greater need for accountability mechanisms. However we would urge the Government not to impose particular thresholds before conducting further research into the potential costs and benefits.

Standard reporting to government grantors

AICD understands that recipients of grants are subject to significant burdens in meeting a variety of obligations imposed by different government departments when reporting on the acquittal of grants received. Reporting by grant recipients could likely be made more efficient and cost effective through the Standard Business

¹⁸ Discussion paper: Financial reporting by unlisted public companies (June 2007), available at <http://www.treasury.gov.au/contentitem.asp?NavId=037&ContentID=1269>

Reporting project currently being undertaken by Treasury,¹⁹ along with an NFP accounting standard as discussed above.

Models of regulation and legal forms that would improve governance and management of charities and not-for-profit organisations and cater for emerging social enterprises

Governance regulation is fragmented and complex

Concern has been expressed about the general impact of incremental governance regulation on companies generally, and NFPs specifically. The resourcing implications flowing from governance regulation are more significant for NFPs than they are for other companies because they have less financial resources, limited pools of expertise and less specialisation at their disposal.²⁰ For this reason, the governance regulation of NFPs should be simplified.

Business man and philanthropist, David Gonski AC has argued that the *Corporations Act* does not differentiate sufficiently between NFPs and for-profits and in order to increase corporate social responsibility, we need an effective NFP sector.²¹ Gonski has proposed that a special NFP entity be established involving the referral of state powers to the Commonwealth. This would ensure consistent regulation and minimise the regulatory complexity that exists.

AICD believes that there should be a single regulatory regime covering all NFPs. However, the regime should be based on size thresholds so that the governance and reporting requirements reflect the relative complexity and size of the NFP. The regime must be able to be applied to both the smaller NFPs with volunteer staff and directors who are not necessarily experienced as well as to the larger NFPs who have full time staff and may remunerate their directors.

While any governance and reporting requirements covering smaller NFPs must be simple enough for volunteers to follow, some level of oversight by a regulator is vital. The community at large has expectations of a high level of accountability on the part of those handling funds donated by members or, granted by government. Compliance obligations on NFPs should be kept cost-effective so as to ensure that they use their scarce resources on achieving social impact rather than on regulatory compliance.

¹⁹ <http://www.sbr.gov.au/content/default.htm>

²⁰ Gabrielle Upton "When Size Matters - in Search of more Meaningful Ways to Regulate Small Corporations", *Company Director*, August 2007, p38

²¹ David Gonski AC, speech given at the Federal Court/Law Council Joint Seminar on Corporations Law, March 2006

Extension of business judgment rule

Whilst NFPs have the objective of social impact, NFP directors can be subject to the same duties and exposure to personal liability as directors of for profit companies. This may act as a deterrent to individuals who wish to volunteer their time and expertise to assist NFPs. AICD supports the expansion of the business judgement rule (s180(2) *Corporations Act*) to NFPs so as not to dissuade well qualified people from taking up directorships in the sector. We made a similar point in relation to for-profits in our 2007 submission to the Treasury discussion paper on corporate sanctions.²²

Currently the business judgement rule only operates in respect of a director's duty of care and diligence under s180(1) *Corporations Act* and equivalent duties under the common law. AICD has proposed that the defence should be available where directors had acted in a bona fide manner, informed themselves about the subject matter to the extent they believe reasonably appropriate and reasonably believe it is in the best interests of the company. Treasury's response on corporate sanctions is expected later this year.

A single regulator

The single regulatory regime covering all NFPs should be operated by a single regulator. We note that there are already separate regulators for charities in NZ & UK. The Committee should explore whether a similar model would be appropriate for all NFPs in Australia.

Some have suggested that a single regulator should be a specialist unit of ASIC, others that it should be a specialist statutory body. AICD does not have firm view in this regard. We urge the Committee to consult widely in order to determine the most appropriate form of national regulator and where it should be sited. In any event, adequate funding for the regulator is imperative.

93 ways to determine charitable status

According to the National Roundtable of Nonprofit Organisations, ninety-three government entities determine charitable status and entitlements, while not recognising their counterparts' findings.²³ Such a lack of clarity imposes an unacceptable red tape burden on NFPs.

²²AICD submission available at <http://www.companydirectors.com.au/Policy/Submissions/2007/>

²³ "Reform is vital for non-profits," *Australian Financial Review*, 2 September 2008, p. 63

Other measures that can be taken by government and the not-for-profit sector to assist the sector to improve governance, standards, accountability and transparency in its use of public and government funds

Additional measures that could assist the NFP sector include:

- Widespread consultation and detailed consideration of the vast body of previous work in this area needs to be undertaken before any new system is put in place.
- Any new regulation of the NFP sector should be reviewed in light of the *Business Checklist for Commonwealth Regulatory Proposals*.²⁴ The checklist expands upon the six principles of good regulatory process endorsed by the previous Government, namely:
 - establish a case for action;
 - examine alternatives to regulation;
 - adopt the option that generates the greatest net benefit to the community;
 - provide effective guidance to relevant regulators and affected stakeholders;
 - review regularly to ensure the regulation remains relevant and effective; and
 - consult effectively with stakeholders at all stages of the regulatory cycle.

Summary

The main objective should be simplification to achieve a consistent national regulatory framework for NFPs which allows these entities to clearly and consistently demonstrate their accountability to their stakeholders through high quality disclosure frameworks. The framework must take into account their objective of long term societal change where business efficiency is not an end in itself. Cost burdens need to be balanced against the benefits of any disclosure regime. Smaller NFPs should be relieved of reporting and disclosure burdens which impose costs and distract them from their core mission, with no commensurate benefit.

A 'light touch' needs to be applied to financial and governance regulation of NFPs, so that members of the community are not dissuaded by red tape from contributing their time, expertise and money to the sector.

²⁴ Business Checklist for Commonwealth Regulatory Proposals (2007). The Checklist is an initiative of leading business groups including AICD to put federal government performance in cutting red tape under closer scrutiny. It is available at <http://www.companydirectors.com.au/Policy/Policies+And+Papers/2007/>